Seven Seas Technologies Limited v Commissioner of Domestic Taxes (Income Tax Appeal 8 of 2017) [2021] KEHC 358 (KLR) (Commercial and Tax) (10 December 2021) (Judgment)

Neutral citation: [2021] KEHC 358 (KLR)

REPUBLIC OF KENYA

IN THE HIGH COURT AT NAIROBI (MILIMANI COMMERCIAL COURTS)

COMMERCIAL AND TAX

INCOME TAX APPEAL 8 OF 2017

MW MUIGAI, J

DECEMBER 10, 2021

BETWEEN

SEVEN SEAS TECHNOLOGIES LIMITED .... APPELLANT

AND

COMMISSIONER OF DOMESTIC TAXES .... RESPONDENT

(Being an appeal from the judgment of the Tax Appeals Tribunal at Nairobi delivered on the 8th day of December 2016 in the Tax Appeals Tribunal Tax Appeal No. TAT/ 94 of 2015)

Annual subscriptions paid by a supplier and distributor of copyrighted items could be deemed as royalties liable for deductions of withholding tax.

Reported by Ribia John

Intellectual Property Law *– copyrights – licences – licence to distribute copyrighted items - what was the nature and scope of a licence under copyright law - what rights did a licence under copyright law confer - whether a licence that was granted vide an end user licence agreement was a licence which transferred an interest in all or any rights of the copyright - Copyright Act, Act No.12 of 200, sections 2, 30 and 33.*

Tax Law *– withholding tax – withholding tax on royalties – what constituted royalty payments in copyrighted items – whether annual subscriptions paid by a supplier and distributor of copyrighted items could be deemed as royalties that would be liable for deductions of withholding tax – whether the supplier/vendor of a copyrighted item could be commercially exploiting the copyright in the copyrighted item by buying and selling the copyrighted item – whether withholding tax should be taxed on payments made for the purchase of software and licences - Income Tax Act (cap. 470) sections 2 and 35; Organization for Economic Co-operation and Development (OECD) Model Tax Convention on Income and on Capital, paragraphs 13.1 and 14.4 of article 12.*

Brief facts

The appellant, a distributor of computer software licences, filed a memorandum of appeal against the decision of the Tax Appeals Tribunal Judgment. The tribunal held that the appellant, in distributing software, acquired

rights to copyright in software, which it commercially exploited, and ought to pay withholding tax. Aggrieved, the appellant filed the instant appeal on grounds that the tribunal erred in its decision that withholding tax applied on payments for copyrighted material purchased by the appellant for purposes of distribution. The appellant claimed that the tribunal erred in failing to consider that the appellant was a vendor of copyrighted material and not the user of the copyright and in that regard did not receive any right to exploit the copyright and as such was not liable to pay withholding tax. The appellant also urged the court to find that the payment for a distribution licence did not amount to payment of royalty.

Issues

i. What was the nature and scope of a licence under copyright law?
ii. What rights did a licence under copyright law confer?
iii. Whether a licence that was granted *vide* an end user licence agreement was a licence in terms of section 30 of the Copyright Act (a licence which transferred an interest in all or any rights of the copyright).
iv. Whether annual subscriptions paid by a supplier and distributor of copyrighted items could be deemed as royalties that would be liable for deductions of withholding tax.
v. Whether the supplier/vendor of a copyrighted item could be said to be commercially exploiting the copyright in the copyrighted item by buying and selling the copyrighted item.
vi. Whether withholding tax should be taxed on payments made for the purchase of software and licences.

Relevant provisions of the Law

Copyright Act, Act No.12 of 2001

Section 2 - Interpretation

(1) In this Act, unless the context otherwise requires—

"licence" means a lawfully granted licence permitting the doing of an act controlled by copyright;

Section 33 - Assignment and licences

(1) Subject to this section, copyright shall be transmissible by assignment, by licence, testamentary disposition, or by operation of law as movable property.

Income Tax Act (Cap. 470)

Section 2 - Interpretation

(1) In this Act, unless the context otherwise requires—

"royalty" means a payment made as a consideration for the use of or the right to use—

(a) any copyright of a literary, artistic or scientific work; or

(b) any cinematograph film, including film or tape for radio or television broadcasting; or

(c) any patent, trade mark, design or model, plan, formula or process; or

(d) any industrial, commercial or scientific equipment,or for information concerning industrial, commercial or scientific equipment or experience, and any gains derived from the sale or exchange of any right or property giving rise to that royalty;

Section 35 - Deduction of tax from certain income

(1) Every person shall, upon payment of any amount to any non-resident person not having a permanent establishment in Kenya in respect of—

(b) a royalty or natural resource income;

Organization for Economic Co-operation and Development (OECD) Model Tax Convention on Income and on Capital.

Paragraphs 13.1 and 14.4 of article 12

13.1 Payments made for the acquisition of partial rights in the copyright (without the transferor fully alienating the copyright rights) will represent a royalty where the consideration is for granting of rights to use the program in a manner that would, without such licence, constitute an infringement of copyright. Examples of such arrangements include licences to reproduce and distribute to the public software incorporating the copyrighted program, or to modify and publicly display the program. In these circumstances, the payments are for the right to use the copyright in the program (i.e. to exploit the rights that would otherwise be the sole prerogative of the copyright holder).

14.4 Arrangements between a software copyright holder and a distribution intermediary frequently will grant to the distribution intermediary the right to transactions, the rights acquired in relation to the copyright are limited to those necessary for the commercial intermediary to distribute copies of the software program. In such transactions, distributors are paying only for the acquisition of the software copies and not to exploit any right in the software copyrights. Thus, in a transaction where a distributor makes payments to acquire and distribute software copies (without the right to reproduce the software), the rights in relation to these acts of distribution should be disregarded in analyzing the character of the transaction for tax purposes. Payments in these types of transactions would be dealt with as business profits in accordance with Article 7. This would be the case regardless of whether the copies being distributed are delivered on tangible media or are distributed electronically (without the distributor having the right to reproduce the software), or whether the software is subject to minor customization for the purposes of its installation.

Held

1. A licence was a grant of authority to do a particular thing, it enabled a person to do lawfully what he could not otherwise lawfully do. A licence did not, in law, confer a right. It only prevented that from being unlawful which, but for the licence, would be unlawful. It amounted to consent or permission by an owner of a copyright that another person should do an act which, but for that licence, would involve an infringement of the copyright of the licensor. A licence gave no more than the right to do the thing actually licenced to be done. It transferred an interest to a limited extent, whereby the licencee acquired an equitable right only in the copyrighted article.
2. The appellant paid for software and licence to access the medium in the software. Whether the payment/consideration was royalty would depend on whether, the payment was to copyright holder or that the licence purchased on the software was unrestricted and unlimited and it conferred the right to use the copyright.
3. The software lease agreement between the parties on purchase/sale of software and/or licences was presented and detailed the terms of the licence as continuous as long as the software existed but subject to certain conditions and terms set out in the Schedule. That was why the court upheld the payment of lease was royalty based on the terms of the agreement.
4. The agreement would shed more light on the legal questions. Whereas it was not denied that there were distinctions of copyright and copyright embedded article and where licences were purchased it did not automatically amount to assignment of the copyright it depended on the terms of the agreement between the parties on the outcome of the audit by the respondent. The audit revealed annual subscriptions and payments for licences. The software purchase agreement stipulated the end-user or licencee was the appellant. The agreement did not set restrictions or limitations of the licence.
5. Copyright was transmittable by licence. Payment of licence fees as consideration of the right to use software fell within the definition of a royalty. However, an agreement would spell out the terms of any right to use or reproduce the copyright work or the licence was to access copyrighted article. The annual subscriptions of licences did not confirm payment as royalty [royalty] as defined referred to some device, formula or contraption which the user applied to make something else and in return for that advantage, the user had to pay the original creator of the capital asset.
6. In the absence of the software sales agreement signed between Callidus Software Inc and the respondent, a software supply contract had no restrictions. The terms of the licence were not stipulated

so as to confirm whether rights were transferred or it was only for the purposes of accessing software or not. Secondly, if the licence was restricted for software to be used internally only or for resale without transfer. It had not been proved that funds paid to Callidus Software Inc were royalty so as to attract withholding tax.

7. International guidelines were part of the law in respective countries but were international best practices that guided the interpretation of laws and regulated international business transactions. The tribunal erred in concluding that by buying and selling computer software, which was a copyrighted item, the appellant was commercially exploiting the copyright in that copyrighted item. In the absence of the agreement(s) that set out the terms of the licence, the appellant was a vendor of a copyrighted item and therefore the copyright was not transmissible.
8. The principles and processes were subject to proof which from the facts of the matter remain contested. The issue of the appellant having purchased a copyright or copyrighted article was debatable and the issue of whether the licence transferred a right to the appellant or merely facilitated the access to software was also unproven.
9. The Organization for Economic Co-operation and Development (OECD) Model Tax Convention on Income and on Capital provided that in such transactions, distributors were paying only for the acquisition of the software copies and not to exploit any right in the software copyrights. Therefore, payments in those types of transactions should be dealt with as business profits and not as royalties. The tribunal erred in failing to consider that the appellant was a vendor of copyrighted material and not the user of copyright and in that regard did not receive any right to exploit the copyright.
10. The appellant was not subject to pay royalties and in turn not liable to pay withholding tax to the respondent with regard to the distribution of the computer software.

Appeal was allowed and the decision of the tribunal was set aside.

Citations

Cases

East Africa;

1. *Barclays Bank of Kenya Limited v Commissioner of Domestic Taxes* (Tax Appeal 8 of 2018; [2020] eKLR) — (Mentioned)
2. *Commissioner of Domestic Tax vs Barclays Bank of Kenya Ltd* Tax Appeal 8 of 2018; [2020] eKLR — (Explained)
3. *Kenya Commercial Bank v Kenya Revenue Authority* Civil Appeal 14 of 2007; [2008] eKLR) — (Explained)
4. *Republic v Commissioner of Income Tax & another* Miscellaneous Civil Application 212 of 2004; [2005] eKLR — (Explained)
5. *Unilever Kenya Limited v Commissioner of Income Tax* Income Tax Appeal No 753 of 2003; [2005] eKLR — (Explained)
6. *National MicroFinance Bank Ltd v Commissioner -General Tanzania Revenue Authority* 15th May 2015 — (Cited)

India

1. Commissioner of Income Tax and Another Vs M/s Synopsis International Old Ltd 3rd August 2010 — (Explained)

2. *Engineering Analysis Centre of Excellence Private Ltd vs Commissioner of Income Tax* Civil Appeals No 8733-8734 — (Explained)

3. *Tata Consultancy Services vs State of Andhra Pradesh* ((271ITR 401) 2004 Pg 99- 122) — (Explained)

4. *Dassault Systems KK v DT* [2010] 322 ITR 125 (AAR) — (Mentioned)

United Kingdom

Cape Brandy Syndicate v Inland Revenue Commissioners (1920) 1 KB 64 — (Explained)

Statutes

East Africa;

1. Civil Procedure Act (cap 21) section 78(1)(d) — (Interpreted)
2. Copyright Act (cap 130) sections 3, 22(1)(a); 26 (1) — (Interpreted)
3. Income Tax Act (cap 470) sections 2 , 2(1); 34(2); 35(1)(b) — (Interpreted)

Texts & Journals

1. Caddick, N., & *et al* (Eds) (2021) Copinger and Skone James Book on Copyright Sweet and Maxwell 13th Edn, para 5-6 p 101 & 102

Advocates

None mentioned

JUDGMENT

Memorandum of Appeal

1. The appellant filed memorandum of appeal dated February 3, 2017 against the Hon Tax Appeals Tribunal Judgment delivered on December 8, 2016. The Tribunal held that the appellant acquired rights to copyright in software which it commercially exploited and ought to pay withholding tax. The appeal is based on the following grounds:

    1. The Tribunal correctly ruled that there is a distinction between a copyright and copyrighted material but erred in its decision that Withholding tax applies on payments for copyrighted material purchased by the appellant.
    2. The Tribunal erred in concluding that by buying and selling computer software, which is a copyrighted item, the appellant was commercially exploiting the copyright in that copyrighted item.
    3. The Tribunal erred by failing to consider that payments for the acquisition of copyrighted material do not fall within the ambit of under section 2 of the *ITA* which defines royalty hence Withholding tax does not apply.
    4. The Tribunal incorrectly applied the provisions of section 35 of the *ITA*. The appellant did not pay a royalty hence the provisions of section 35 do not apply.
    5. The Tribunal erred in failing to consider that the appellant is a vendor of copyrighted material and not the user of a copyright and in this regard does not receive any right to exploit the copyright.
    6. The Tribunal erred in law by holding that the appellant did not demonstrate that it did not make use of or exploit the copyright on the copyrighted software in its possession. The appellant has no obligation to demonstrate this under section 35 or any other provision of the ITA.
    7. The Tribunal erred in law by failing to consider and ruling contrary to international best practice as set out in the Organization for Economic Co-

operation and Development Model Tax Convention on Income and on Capital. Paragraph 2 of article 12 provides that;

“ The term "royalties" as used in this article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.”

Paragraph 8.2 of the commentary on article 12 states that:

Where a payment is in consideration for the transfer of the full ownership of an element of property. The payment is not in consideration "for the use of or the right to use" that property and cannot therefore represent a royalty.

8. It is proposed to ask for the court for an order that:

a) This appeal be allowed and the Judgment of the Tax Appeals Tribunal as holds that the appellant acquired rights to the copyright in software which it commercially exploited, be set aside and be substituted therefor with an order allowing the said appeal with costs to the appellant therein.

b) The costs of this appeal be awarded to the appellant

c) Any other alternative relief the court may deem fit to grant.

Respondent’s Statement of Facts

2. The respondent filed a response to the memorandum of appeal dated March 3, 2017 as follows;

1. The appellant was registered for an In-depth audit as per the *Income Tax Act* and the Value Added Tax Act in November 2013. Following a request by the Appellant the commencement date was postponed to February 2014. Several meetings were held in 2014 where findings presented, explanations given, documents availed and subsequently a demand issued on 30th October, 2014. (Page 87 to 90 of the respondent's bundle of documents).

2. Among the findings arising from the audit is that the Company was not deducting Withholding tax on payment to non-resident persons in respect of software licenses. Total withholding tax demanded thereon was Ksh 21,525,013/- which comprised of software the appellant alleged was for resale Ksh 15,320,673 while software purchased by the appellant for its own use was charged at Ksh 6,204,340.67/- thus the total of Ksh 21,525,013/-

3. Payment for software was taken as a payment of royalty as it is consideration for the use and right to use copyright of the literary work of another person as per section 2 of the *Income Tax Act*.

4. The appellant objected to some of the findings vide letter dated November 28, 2014. (Page 86 of the respondent's bundle of documents). The respondent reviewed the appellant's objection and made a decision to affirm its position vide a letter dated December 15, 2014 demanding the Withholding Tax (Page 19 to 26 of the respondent's bundle of documents).

5. The appellant thereafter filed a notice of appeal to the Local Committee dated December 30, 2014. (Page 87 of the respondent's bundle of documents). The Tribunal heard the Appeal and delivered its judgment on December 8, 2016 in favor of the respondent which held thepayment for computer software demanded ought to be paid by the appellant.

6. The respondent stated that Withholding tax was charged guided by paragraph (a) of the aforesaid definition which is that " Royalty" is a payment made as a consideration for the use of or the right to use the copyright of a literary work.

7. The respondent maintained that whether software was purchased for resale or for own use, withholding tax would be collected. This is guided by the definition of the term royalty as per section 2 of the *Income Tax Act*.

8. The respondent stated that the appellant would not legally sell the software without authorization from the trademark owner. This authorization would only come upon a payment for a consideration for the right to use the trademark, therefore such payments qualify to be defined as royalties as per the definition of royalties in section 2 of the *Income Tax Act*.

9. The Callidus Software which is one of the subjects of this appeal was purchased by the company through a software purchase contract signed on September 30, 2009 (and payments made in 2010. This contract refers to a Software sales agreement between Callidus Software Inc and Seven Seas Technologies Page 43 to 44 of the respondent's bundle of documents).

10. The aforesaid Callidus software was reported in the balance sheet of the appellant as an asset. The same was not purchased for resale as alleged by the appellant as no evidence was adduced by the appellant to confirm that the software was resold.

11. The respondent therefore stated that withholding tax was chargeable upon payment of the license fee as per section 35 of the *Income Tax Act* and therefore the outstanding liability of Kshs 15, 320, 673 is due and payable.

12. The respondent also stated that use of copyright does not necessarily mean reproduction or exploitation. The fact that appellant was using the intellectual property of another entity which is protected by a copyright then made the payment thereof a royalty as per the definition of "Royalty" in the *Income Tax Act*.

13. The respondent maintained that Software is not a good neither is it a service but an intellectual property belonging to the inventor. Software can only be sold by way of the developer selling the right that he has over his invention otherwise he stands not to gain economically for his invention. The proceeds from sale of intellectual properties are royalties.

14. The respondent maintained that Withholding tax of Kshs 6, 204, 340.67 is due and payable by the appellant as computed on software purchased for use by the appellant in his business from alleged shrink-wrapped software.

15. The respondent further averred that the decision of the Tribunal was not made in ignorance of the law and facts of the case as alleged by the appellant but that

the same was made with due consideration of the relevant provisions of the *Income Tax Act*.

16. The respondent urged the court to uphold the decision of the Tribunal and find that the outstanding amount of Withholding Tax of Kshs 21,525,013.00 is due and payable by the appellant.

3. On 4th April 2019, this court invoked section 78(1)(d) *Civil Procedure Act* and sought additional evidence, that each party would avail evidence of an expert and they filed Witness statements/ submissions. Oral high lights of the expert evidence was on February 26, 2021.

Additional Evidence

Appellant' Case; Claude Kamau Mwangi

4. The witness is an Advocate of the High Court of Kenya, with LLB & Masters' Degree from Strathmore University and is specialized in Property law & Intellectual property. He relied on the filed Witness Statement on line and testimony in court made on February 26, 2021.

5. He said that royalties as a term can only be used to describe payments made with respect to either of the 2 categories; Licenses and Assignments. Royalties is a tax term under section 2 on *Income Tax Act* and an Intellectual property term/concept that connotes fees due to a copyright owner by Assignee of Licensee. According to the Witness, the Appellant acquired physical medium in which copyrighted software is embedded and did not acquire software through license or assignment. The software gives the physical item the copyright item and it is not synonymous with acquisition of a right under license of assignment.

6. He stated that to distinguish trading in a market with tax component one needs to identify the tax character;

    a. A mere sale of an item

    b. Absolute acquisition of an item- Assignment

    c. Limited acquisition of a right- License

7. At paragraph 20-25 of his Statement, the witness described an assignment is a transfer of ownership. It maybe partial, in the sense of transferring only some of the owner's exclusive rights or in transferring ownership for only a limited period, as opposed to the whole term of copyright. To be effective, an assignment must be in writing signed by or on behalf of the Assignor.

8. He averred that an assignment is in exchange of payment of royalty. A License does not involve transfer of ownership, but grants permission to carry out certain acts that fall within exclusive rights of the owner. In a license no proprietary interest is passed to Licensee, it merely is merely permits the Licensee to do the acts with respect to the copyright which would amount to infringement if the license was not granted.(section 33 of *Copyright Act*).

9. According to the Witness, Payments in respect of licenses and assignments are considered royalty and are payable under section 34(2) of ITA if pursuant to an agreement, the [Purchaser] does not acquire any rights to use or reproduce the copy right work, it is not an assignment or License.

10. There is a distinction between a copyright and copyright- embodying article. Copyright itself attracts royalty taxes, the sale of copyright articles would only attract business income tax.

11. The Witness relied on the case of *Tata Consultancy Services vs State of Andhra Pradesh (271ITR 401) 2004 Pg 99- 122* where Indian Court held that software when put in a medium is goods for sale not copyright.

Respondent's Case; David Mugo Mwangi

12. The Witness holds degree in Economics & Government from University of Nairobi, he is a trained Tax Auditor with 29 years' experience in Tax Administration.

13. The witness relied on Witness Statement of October 24, 2019, and testimony in court on March 16, 2021 and stated that the appellant is an Information Communication Technology (ICT) Company that provides ICT Infrastructure, Technical Personnel, ICT Equipment, Software & Consultancy in the field. The appellant was profiled for an indepth audit for the period from January 2010- 2013 due to phenomenal growth in turnover without corresponding growth in taxes paid.

14. The Witness stated that notice was issued on October 18, 2013 of the intended audit and identified documents to be availed as outlined in Paragraph 11& 14 of the Witness Statement. The Witness led the audit team and audit was from February to October 2014.

15. The Audit revealed various clients that the appellant serviced through ICT needs both locally and within the East & Central African region. The Audit revealed that the appellant deducted Withholding tax on payment of consultancy and contractual fees but not on software licenses. The respondent took the view that payment of software Licenses amounts to payment of royalties and therefore subject to withholding tax under section 35(1)(b) of *Income Tax Act*.

16. The Witness noted at Pargraph 29-33 of the Witness Statement, that the appellant did not produce the Software Sales Agreement signed between Callidus Software Inc & the appellant Company and the Respondent relied on the Schedule to the Agreement. The Contracts and Invoices confirmed purchase of Licenses.

17. The Software Purchase Agreement has the License Schedule and depicts its true nature as a mere license to use licensors software as distinguished from a purchase Agreement. What was transferred to the appellant is only a license or permission to use software supplied by Callidas USA under those terms and conditions of License. The payments of license Fees was consideration for the right to use the software, which is within the definition of a royalty under *Income Tax Act*.

Appellant's Submissions

18. It was the appellant's submission that in order for a payment to be considered a royalty it must be made in consideration for the use of or the right to use a copyright. The ITA does not provide a definition of a 'copyright' nor does it define a 'literary work'. The appellant therefore relies on the provisions of the *Copyright Act*, 2001 for the definition of these terms. Section 22(1)(a) of the *Copyright Act*, 2001 determines works eligible for copyright as follows:

    Section 22 Works eligible for copyright

    (1) Subject to this section, the following works shall be eligible for copyright- (a) literary works;

Section 2(1) of the *Copyright Act*, 2001 defines a 'literary work' as follows:

> "literary work" means, irrespective of literary quality, any of the following, or works similar thereto- (h) computer programs;"

19. From these provisions, there is an unequivocal statutory basis that provides that computer programs may be literary works which are eligible for copyright.

    Section 2(1) of the *Copyright Act*, 2001 defines a

    > "computer program" as a set of instructions expressed in words, codes, schemes or in any other form, which is capable, when incorporated in a medium that the computer can read, of causing a computer to perform or achieve a particular task or result;"

20. From this definition, what is copyrightable is the set of instructions rather than particular medium (copyrightable material) on which the software is incorporated.

21. *Copinger and Skone James book on Copyright (Thirteenth Edition, paragraph 5-6 at page 101 and 102) published by Sweet and Maxwell further* makes the distinction between copyright and physical material and clarifies the rights that are transferred when copyrighted work is transferred as follows:

    > "Distinction between title to copyright and physical material. The ownership of copyright in a work is distinct from the ownership of the physical material in which the copyright work is embodied. The transfer of title to the physical material does not necessarily transfer the title to the copyright, any more than the assignment of the copyright necessarily transfers the title to the physical material.The purchaser of a book, for example, becomes the owner of the book, but he does not thereby become the owner of any part of the copyright in the literary work reproduced in the book. The copyright in the literary work remains with the copyright owner who enjoys and is entitled to enforce all the exclusive rights of copying, publication, sale and so on conferred on him by copyright law. The sale of a book does not necessarily confer on the purchaser any right, either by way of assignment or license, to exercise any of those exclusive rights."

22. The appellant submitted that by purchasing software, it acquired copyrighted material and it did not in any way acquire the rights to the Intellectual Property, that is, the Copyright in the software.

23. Moreover, in the case of *Republic v Commissioner of Domestic Taxes Large Tax Payer's Office ex-parte Barclays Bank of Kenya Ltd* (2012] eKLR the court observed that:

    > "The approach of to this case is that stated in the oft cited case of *Cape Brandy Syndicate v Inland Revenue Commissioners (1920) 1 KB 64* as applied in TM Bell Commissioner of Income Tax (1960) EALR 224 where Roland J stated, "in a Taxing Act, one has to look at what is clearly said. There is no room for intendment as to a tax. Nothing is to be read in, nothing it to be implied. One can only look fairly at the language used... If a person sought to be taxed comes within the letter of the law he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the spirit of the law the case might otherwise appear to be."

24. The appellant submitted that by purchasing software, it acquired copyrighted material and it did not in any way acquire rights to Intellectual Property, that is the Copyright in the software.

25. The distinction between 'copy right' and 'copy righted material', the respondent ought to consider the rights which the grant of copy right confers.Section 26(1)of Copy Right Act 2001 defines what cannot be considered as infringement of copyright. Section 2 of the Copy Right Act defines 'License' as permitting the doing an act controlled by copyright. Therefore, payment may only be deemed to be a royalty where it results in section 26(1) of Copy Right Act 2001.

26. When a developer sells copyrighted material he does not sell his right to the invention as the developer sells a copy of the invention to a purchaser which can be used by the purchaser but cannot be developed by the purchaser, the purchaser also does not have the right to make copies of the invention. In purchasing the copyrighted material, the appellant did not acquire any of the rights setout under section 26 of the *Copyright Act*, 2001. Reference was made to the case of *Dassault Systems KK v DT [2010]322 ITR 125 (AAR)* to buttress the point payments received by software developers from 3rd party sellers on account of supply of software products to the end users did not result in royalty income.

27. In *Republic vs Commissioner of Income Tax & Anor [2005]eKLR* Hon Ojwang J (as he then was) held;

> ...royalty as defined refers to some device, formula or contraption which the user applies to make something else and in return for that advantage, the user must pay the original creator of the capital asset.

28. In the case of *Unilever Kenya Ltd vs Commissioner of Income Tax [2005] eKLR* Hon Viram J (as he then was) observed;

> I have noticed that the very lengthy submissions made by UKL on guidelines adopted by other countries have been ignored by the respondent on the basis that these simply do not apply to Kenya. Now, these guidelines do not form the laws of the countries in question they are simply guidelines, guiding the world of business, that is business enterprises and taxing authorities of those countries in arriving at proper transfer pricing principles for the purposes of computation of Income Tax......

29. The appellant further submitted that Paragraph 10.1 of the OECD (Model Tax Convention) MTC Commentary to article 12 provides that:

> "Payments that are solely made in consideration for obtaining the exclusive distribution rights of a product or service in a given territory do not constitute royalties as they are not made in consideration for the use of, or the right to use, an element of property included in the definition."

30. Paragraph 14.4 of the OECD Model Tax Convention (MTC) commentary to article 12 provides that:

> "Arrangements between a software copyright holder and a distribution intermediary frequently will grant to the distribution intermediary the right to distribute copies of the program without the right to reproduce that program . In these transactions, the rights acquired in relation to the copyright are limited to those necessary for the commercial intermediary to distribute copies of the software program. In such transactions, distributors are paying only for the acquisition of the software copies and not to exploit any right in the software copyrights. Thus, in a transaction where a distributor makes payments to acquire and distribute software copies (without the right to reproduce the software), the rights in relation to these acts of distribution should be disregarded in analysing the character of the transaction for tax purposes.'

31. When a party acquires copyrighted material; it does not acquire any right in the intellectual property of the copyright. Commercial exploitation would only be possible if the appellant would have the right to make copies of the software which right the appellant does not hold. Distribution of the copyrighted article, that is, the software to third parties does not fall within the definition of using the intellectual property in the software.

Respondent's Submissions

32. The respondent submitted that Callidus Inc USA is a non-resident person who received consideration for software procured by the appellant, hence tsection 35(1)(b) of the *Income Tax Act* (ITA) as read with section 2 of the ITA. The consideration paid was for the use of or right to use the copy right of a literary work, in this case the software.

33. The respondent further submitted that the appellant exploited the intellectual property in the software when it resold the software to its customers and therefore, the proceeds from the same are also royalty as envisaged under the aforesaid sections of the ITA. Without entering into a license Agreement the appellant was not permitted or allowed to use the software, which exclusively belongs to Callidus USA

34. That the appellant pays a cost for use of the software and that by use of the software, a right is conferred on the appellant. The appellant was given a right to use the software whether for own use, resale or distribution purposes, on payment of a cost stipulated in the Software Purchase Agreement.

35. Section 2 of the *Income Tax Act* defines of Royalty as follows:

> "Royalty" means a payment made as a consideration for the use of
>
> or the right to use-
>
> a. the copyright of a literary, artistic or scientific work; or
>
> b. a cinematograph film, including film or tape for radio or television broadcasting; or
>
> c. a patent, trade mark, design or model, plan, formula or process; or
>
> d. any industrial, commercial or scientific equipment

36. It is clear from the finding of the Tribunal that the appellant could use the software for its own use and for resale and that consideration paid for the same would amount to royalties. This is because there are some rights that were embedded in the software, which both the appellant and its customers enjoyed when they each used the software.

37. The respondent submitted that in this case what was transferred when the appellant used the software or sold it to its customers were rights that were embedded in the software which were enjoyed by the appellant and its customers. It is therefore misleading for the appellant to suggest that no rights were enjoyed by it or its customers when it bought the software. The respondent therefore submitted that what was transferred in this case was a right in respect of a copyright and not a right in the copy copyright.

38. The appellant was given a license for the software and that going by the aforesaid decision any consideration paid for any rights to the software (ie whether for own use or resale) in this case is subject to royalty. This is because in either of the circumstances there are rights in respect of copyright that are being enjoyed by the appellant and or his customers from the use of the software.

39. In the case of *Kenya Commercial Bank versus Kenya Revenue Authority [2008] eKLR* LJ Lesiit (as she then was) asserted that the definition of the term Royalty as per the Act is wide to enable the Commissioner of Tax to collect Withholding tax on both local and offshore transactions.

> "The definition given to 'royalty' is wide which I think is an indication of the extensive range of underlying transactions giving rise to a royalty that the Income Tax Commissioner would target. The width of the definition is also important because in my view, it gives the Commissioner the right to seek withholding tax on royalty payments made offshore, and on the other hand he would expect to see similar payments being received in Kenya by the holders of Kenyan Intellectual Property that is used outside Kenya."

40. The respondent submitted that the court should therefore arrive at the same finding that the monies that were paid out by the appellant to the owners of the software, Callidus Inc (USA), (a non-resident person) as consideration for the use of or right to use the software by itself and or its customers attracted were royalties as envisaged under section 35(1)(b) of the ITA as read with the definition of "Royalty" under section 2 of the ITA.

41. The respondent argued that it would be absurd to separate the copyright from the copyrighted material because the software in this case is an intangible and the right being enjoyed is the right in respect of the copyright that is embedded in the software. Whether the software was purchased for resale or for own use the Withholding tax would still be collected as they are royalties under definition in the ITA. Therefore, the appellant's arguments that the transactions in this matter be considered to be in relation to copyrightable material is mischievous and aimed at defeating the collection of tax that is due.

42. The consideration paid by the appellant to use the software for personal use within its business amounts to royalty. This is because the appellant by using the software is enjoying a right in respect of copyright in the software.

43. In addition, the assessments of taxes for the taxes in this matter were conducted in accordance with the sections 35(1)(b) as read with section 2 of the *Income Tax Act* as already explained in all the forgoing paragraphs and that the Judgment by the Tribunal must therefore be upheld.

44. Further, that in arriving at the assessments followed the due process, carried out the necessary tests and verification exercises and further admitting any information and records from the appellant in arriving at the taxes due. All information and records availed by the appellant both at objection of the Commissioner's decision and Appeal to the Tribunal levels were put into consideration when arriving at the taxes due.

45. The respondent relied on case-law to establish how purchase of soft ware is taxed in the following cases;

    a. *Commissioner of Domestic Tax vs Barclays Bank of Kenya Ltd*[2020] eKLR,

    b. *National MicroFinance Bank Ltd vs Commissioner -General Tanzania Revenue Authority* (2019)

    c. *Kenya Commercial Bank vs Kenya Revenue Authority*, HC Income Tax Appeal No 14 of 2017.

46. To buttress the point, the appellant made payments for acquiring the software for its use through a license. The payments were made to Callidus Software Inc. who is non-resident person which the Appellant was obliged to deduct appropriate non-resident Withholding tax as required under the *Income Tax Act*.

Determination

47. The court considered the pleadings filed on the appeal experts' evidence and written submissions by parties through their respective Counsel.

48. The issue that emerged for determination is as set out in the memorandum of appeal condensed as follows;

a. Whether Withholding tax should be taxed on payments made for purchase of software and licenses and whether the payments amount to royalties paid to non-resident under section 35 of ITA or not.

49. The Tax Appeals Tribunal found as follows;

   a. 'To be taxable as royalty the payment for software should have been for the use of or right to use of any copyright.'

   b. 'In other words, a holder of copy right is permitted to exploit the copyright commercially .....clearly, the appellant is in the business of buying and selling Computer programs thus exploiting the computer software commercially which is the very essence of a copyright.'

50. The appellant contended that the Tribunal erred in failing to consider that the appellant is a vendor of copyrighted material and not the user of a copyright and in this regard does not receive any right to exploit the copyright. Further, that payments for the acquisition of copyrighted material do not fall within the ambit of this definition hence Withholding tax does not apply.

51. The appellant's case hinges on payment made to a non-resident person as consideration for software procured and whether the payment qualifies to be taxed under "royalty"

52. The appellant contended that by purchasing software, it acquired copyrighted material and it did not in any way acquire the rights to the Intellectual Property, that is, the Copyright in the software. It was also the appellant's argument that the Tribunal erred in failing to consider that it is a vendor of copyrighted material and not the user of a copyright and does not therefore receive any right to exploit the copyright.

53. The appellant's expert gave detailed intellectual property processes and circumstances where tax would be applied. Admittedly, the expert vide his statement at paragraph 27 opined that 'it is not in dispute that payment of license Fess as consideration of the right to use software falls within the definition of a royalty. If a purported assignee or licensee, however, does not therefore pursuant to an agreement acquire any right to use or reproduce the copyright work, this cannot properly be termed as either an assignment or a license.'

54. The appellant took the view that Withholding tax was not payable under section 2 & 35 of ITA as the appellant did not pay royalties to the non-resident in purchase of software. They bought software which was not changed in any way and it was for resale and own use. They acquired a copyrighted article and not a copyright and no rights of the copyright were transferred or used by the appellant.

55. This was a sales of goods transaction. The respondent on the other hand contended that the appellant purchased licenses and documents presented during audit referred to the respondent as end use licensee with details of license fees to be paid. The license is covered in the definition of royalty. For software which is deemed as literary works this would only be used or passed through sale of a license.

56. The respondent's expert also gave in detail the conduct and outcome of the audit conducted to the appellant and the appellant made payments for acquiring software for its use through a license.

57. In the case of *Commissioner of Domestic Tax vs Barclays Bank of Kenya Ltd [2020] eKLR supra*; the Court of Appeal considered as follows;

> How are we to determine whether payments made by the respondent to the card Companies constitute royalty? Is it as the respondent suggests, by reference only to terms of written Agreement agreements between respondent or the Card Companies? In our view , it is by considering the terms of the statute, written agreements, and the totality of the relationship between the Respondent and card Companies , including actual dealings between parties.

58. The respondent's Expert informed the court that during audit, several documents were availed by the appellant Callidus Software Purchase Schedule and Purchase Invoices of Licenses and the appellant failed to produce the Software Sales agreement signed between Callidus Software Inc dated 30th September 2009.

59. Therefore, the Agreement between the appellant and non-resident Callidus Software Inc and from the documents presented during the audit, the issue of whether royalty was paid to Callidus Software Inc or not the Monies/Fees were for purchase of software and license to access the information in the software is contested as the respondent takes the view that the payment for license amounted to deriving a right from the copyright. It is upon determination of payment of royalty that the Withholding tax would be payable.

60. The appellant's stated as outlined by its Expert, that the Appellant acquired physical medium in which copyrighted software is embedded and did not acquire software through license or assignment from the holder of the copyright. The appellant while admitting payment to Callidus Software Inc for software categorically denies it was royalty so as to attract withholding tax but states it would amount to business tax under Section 34 of ITA.

61. The respondent stated that the business tax payment inapplicable under section 34 ITA as the non-resident would have to file Tax Return for investigation and assessment.

Section 2 of the *Income Tax Act*defines royalty

Further, section 22(1) of the *Copyright Act* **defines Literary work to include Computer Programs.

Section 35 of ITA provides for deduction of tax from certain income

> Every person shall, upon payment of any amount to any non-resident person not having a permanent establishment in Kenya in respect of—
>
> (a) a management or professional fee or training fee except— .....
>
> (b) a royalty or natural resource income;..........

62. License has been defined under section 1 of the *Copyright Act* as;

> "llicense" means a lawfully granted license permitting the doing of an act controlled by copyright;

63. The respondent through its expert confirmed that the respondent had filed Tax Returns for Corporation Tax , Value Added Tax (VAT) & Pay As You Earn (PAYE) and paid self -assessed tax for

the period under audit. After the audit the respondent section 35(1) ITA was payable. The appellant contested the Withholding tax on the basis that they did not pay royalties.

64. This court was referred to the case of *Engineering Analysis Centre of Excellence Private Ltd vs Commissioner of Income Tax Supreme Court of India Civil Appeals No 8733-8734* where it reads in part;

In all these cases, the licence that is granted vide EULA, is not a license in terms of section 30 of the *Copyright Act* , which transfers an interest in all or any rights but a licence that imposes restrictions or conditions for the use of computer software.........

What is licensed by the foreign, non-resident supplier to the distributor and resold to the end -user or directly supplied to the resident end -user is in fact the sale of a physical object which contains an embedded computer program and is therefore sale of goods.

65. The case applied to the instant appeal , means that the parties ought to have established from the Agreements documents , relationship of the parties' and totality of the circumstances of the matter, whether the software purchased by the appellant was a copy right or copy righted article in a sale of goods or license.

66. The appellant reiterated its position, that it purchased copy righted article for its own use and resale as was confirmed from the audit while the respondent contended that by virtue of section 2 & 35 (1) ITA the appellant paid royalty and out to have withheld Withholding tax.

67. This court was also referred to the case of *National MicroFinance Limited vs Commissioner General Tanzania Revenue Authority* N(2019) after the court considered Clauses 2.0 & 2.1 of the Software License Agreement (SLA)that set out the terms of the license, that as long as the software continues to exist and function to the satisfaction of the licensee and subject to the terms and conditions hereinafter appearing, a non-exclusive and non-transferrable right to use the software for internal purpose only.

The Court of Appeal of Tanzania held;

To us, it is clearly discernable from the foregoing article of SLA that what was transferred to the Appellants is only a license to use software which was to be supplied by Neptune under certain terms and conditions. To that extent a proper construction, we do not entertain a flicker of doubt that SLA constituted a lease within definition of the term under section 3 of the ITA,2004. Likewise, we are just as well fully satisfied that the payment of the license fee was a consideration for the right to use software which was within the definition of a royalty under clause (a) of its definition under section 3 of ITA 2004.

68. The bone of contention is whether the appellant paid royalty to non- resident Callidus Software Inc or or not.

69. In *Commissioner of Income Tax and another vs M/s Synopsis International Old Ltd [2010] eKLR* the court held as follows in respect to a license and the rights to a copyright:

> "A license is a grant of authority to do a particular thing, it enables a person to do lawfully what he could not otherwise lawfully do. A license does not, in law, confer a right. It only prevents that from being unlawful which, but for the license, would be unlawful. It amounts to a consent or permission by an owner of copyright that another person should do an act which, but for that license, would involve an infringement of the copyright of licensor." A license gives no more than the right to do the thing the thing actually licensed to be done. It transfers an interest to a limited extent, whereby the licensee acquires an equitable right only in the copyrighted article."

70. From the above outline, this court finds that the Appellant paid for software and license to access the medium in the software. Whether the payment/consideration was royalty would depend on whether, the payment was to copyright holder or that the license purchased on the software was unrestricted and unlimited and it conferred right to use the copyright.

71. Ideally, as in the case cited above by the parties the Software Lease Agreement between the parties on purchase/sale of software and/or Licenses was presented and detailed the terms of the license as continuous as long as the software existed but subject to certain conditions and terms set out in the Schedule. That is why the court upheld the payment of lease was royalty based on the terms of the Agreement.

72. In the instant case, the agreement would shed more light on the legal questions. Whereas it is not denied that there are distinctions of copy right and copyright embedded article and where licenses are purchased it does not automatically amount to assignment of the copyright it depends on the terms of the Agreement between the parties on the outcome of the audit by the Respondent. The audit revealed annual subscription and payment for licenses. The Software Purchase Agreement stipulated the end user or licensee is the Appellant. The Agreement does not set restrictions or limitations of the license. Respondent submitted that the Software Purchase Agreement had a license Schedule within to depict it as a license to use the licensors software as opposed to a Purchase Agreement only.

73. The appellant relied on the following provisions to establish a copy right

Section 33(1) of the *Copyright Act*further provides that;

> (1) Subject to this section, copyright shall be transmissible by assignment, by license, testamentary disposition, or by operation of law as movable property.

74. The definition of copyright as has been defined under section 26 of the *Copyright Act* to include literary works and provides that:

> "Copyright in a literary, musical or artistic work or audio-visual work shall be the exclusive right to control the doing in Kenya of any of the following acts, namely the reproduction in any material form of the original work or its translation or adaptation, the distribution to the public of the work by way of sale, rental, lease, hire, loan, importation or similar arrangement, __and the communication to the public and the broadcasting of the whole work or a substantial part thereof, either in its original form or in any form recognizably derived from the original."

75. The court finds that it is not disputed that that copyright is transmittable by license, that payment of license Fees as consideration of the right to use software falls within the definition of a royalty. However, an agreement would spell out the terms of any right to use or reproduce the copyright work or the license is to access copyrighted article. The annual subscriptions of licences do not confirm payment as royalty[royalty] as defined refers to some device, formula or contraption which the user applies to make something else and in return for that advantage, the user must pay the original creator of the capital asset as described in *Republic v Commissioner of Income Tax & anor* [2005]eKLR *supra*.

76. In the absence of the Software Sales agreement signed between Callidus Software Inc and the respondent, Software Supply Contract has no restrictions. The terms of the license are not stipulated so as to confirm whether rights were transferred or it was only for the purposes of accessing software or not. Secondly, if the license was restricted for software to be used internally only or for resale without

transfer. For these reasons, it has not been proved that funds paid to Callidus Software Inc were royalty so as to attract Withholding Tax.

77. What then is the difference between copyright and copyrighted material? The Tribunal established in its holding that the appellant is primarily into the business of provision of integrated business and technology solution procured from various Enterprise Resource Planning software manufacturers & Developers. The software procured is mainly sold to end users who are their clients, and the appellant is merely a distributor of the software in Kenya.

78. In the Organization for Economic Co-operation and Development (OECD) Model Tax Convention on Income and on Capital. Paragraphs 13.1 and 14.4 of article 12 provide that;

> 13.1 Payments made for the acquisition of partial rights in the copyright (without the transferor fully alienating the copyright rights) will represent a royalty where the consideration is for granting of rights to use the program in a manner that would, without such license, constitute an infringement of copyright. Examples of such arrangements include licenses to reproduce and distribute to the public software incorporating the copyrighted program, or to modify and publicly display the program. In these circumstances, the payments are for the right to use the copyright in the program (ie to exploit the rights that would otherwise be the sole prerogative of the copyright holder). 14.4 Arrangements between a software copyright holder and a distribution intermediary frequently will grant to the distribution intermediary the right to transactions, the rights acquired in relation to the copyright are limited to those necessary for the commercial intermediary to distribute copies of the software program. In such transactions, distributors are paying only for the acquisition of the software copies and not to exploit any right in the software copyrights. Thus, in a transaction where a distributor makes payments to acquire and distribute software copies (without the right to reproduce the software), the rights in relation to these acts of distribution should be disregarded in analyzing the character of the transaction for tax purposes. Payments in these types of transactions would be dealt with as business profits in accordance with article 7. This would be the case regardless of whether the copies being distributed are delivered on tangible media or are distributed electronically (without the distributor having the right to reproduce the software), or whether the software is subject to minor customization for the purposes of its installation."

79. The International guidelines are part of the law in respective countries but are international best practices that guide in interpretation of laws and regulate the international business transactions.

80. In this regard, the Tribunal erred in concluding that by buying and selling computer software, which is a copyrighted item, the appellant was commercially exploiting the copyright in that copyrighted item. Contrary to the above definition of a license, and in the absence of the Agreement(s) that set out the terms of the license, in the instant case the appellant was a vendor of a copyrighted item and was therefore copyright was not transmissible.

81. Further, in *Director of Income Tax versus Ericsson AB,* New Delhi. on 23 December, 2011, the court upheld the decision of the Delhi Income Tax Appellate Tribunal (ITAT) on a similar issue as follows;

> "52. We find that the Tribunal has held that there was no payment towards any royalty and this conclusion is based on the following reasoning: -
>
> (i) Payment made by the cellular operator cannot be characterized as royalty either under the *Income Tax Act* or under the DTAA.
>
> (ii) The operator has not been given any of the seven rights under s 14 (a) (i) to (vii) of the *Copyright Act*, 1957 and, therefore what is transferred is not a copyright but actually a copyrighted article
>
> (iii) The cellular operator cannot commercially exploit the software and therefore a copyright is not transferred."

82. Taking into consideration that the Tribunal held that the appellant was merely a distributor of the software in Kenya, and by the case of *Engineering Analysis Centre for Excellence Private Ltd vs Commissioner of Income Tax* (supra), where the dispute was whether payments for use and resale of computer software made to foreign suppliers or manufacturers through End User License Agreements (EULA) and distribution agreements could be characterized as royalty payments. The Supreme Court of India held such payments could not be considered payments for the use of underlying copy rights in software and were instead sale of goods. Similarly, in the instant case, the TAT found the Appellant a distributor, and at the same time 'exploiting the computer software commercially which is the very essence of a copyright.' As a distributor one purchases and resells as is without tampering or modification right as is exercised by copyright holder so if as stated the Appellant was a distributor then it is not compatible with exploiting the copyright.

83. The issue of whether it was sale of goods or assignment or license of copyright remains hotly contested, the issue of the appellant having purchased copyright or copyrighted article is debatable and the issue of whether the license transferred a right to the appellant or merely facilitated the access to software is also unproven. All these issues center on the proof that the appellant paid royalty to non-resident so as to attract Withholding tax. The experts gave relevant information that guided the court and parties but the principles and processes were/are subject to proof which from the facts of the matter remain contested.

84. The upshot of the above excerpts and the case is that the appellant in this case paid the license fee did not acquire any partial rights in copyright and thus not subject to royalty as argued by the respondent.

85. In addition to the above, the OECD Model Tax Convention on Income and on Capital provides that in such transactions, distributors are paying only for the acquisition of the software copies and not to exploit any right in the software copyrights. Therefore, payments in these types of transactions should be dealt with as business profits and not as royalties.

86. The Tribunal erred in failing to consider that the appellant is a vendor of copyrighted material and not the user of a copyright and in this regard does not receive any right to exploit the copyright.

Disposition

87. It is therefore right to conclude that the appellant was not subject to pay royalties and in turn not liable to pay Withholding tax to the Respondent with regard to the distribution of the computer software. For these reasons the Appeal is allowed and the decision of the Tribunal set aside.

DELIVERED SIGNED & DATED IN OPEN COURT ON 10TH DECEMBER, 2021.

M.W.MUIGAI

JUDGE